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'Monetary capacity'

Even a cursory review of long-run patterns makes the close relationship between monetization and fiscal capacity clear. Breakdowns of monetary systems tend to be associated with falling tax revenues and the collapse of government authority, while a strong fiscal performance usually occurs under monetary stability. Beyond the anecdotal evidence, however, there is little systematic effort to formally model the mechanisms through which monetization and fiscal capacity interact, to empirically identify the causal effects, and to explore the implications of this relationship over the long run.

In broadest terms, our paper investigates the relationship between monetary and fiscal capacity. Monetary capacity refers to a state's capacity to provision and circulate money that is accepted by the public, which in turn determines the monetization level of the economy. This capacity depends on demand-side factors, such as the public's willingness to accept state-issued money. It also depends on supply-side factors, which before the modern fiat money era included the availability of silver and gold. Fiscal capacity, on the other hand, refers to a state's administrative and political capacity to raise taxes, and determines the level of taxation. This capacity depends on the physical infrastructure, bureaucratic know-how and coercive capabilities of the state.

In this study, we analyse the interrelationship between monetary and fiscal capacity comparatively for eight early modern economies: England, Dutch Republic, Spain, France, Portugal, Poland, Russia, and the Ottoman Empire. Moreover, for England, France and Spain we can estimate the causal effect of monetary capacity on fiscal capacity by relying on a natural experiment, instrumenting the money stocks of these countries over 1550-1790 by silver and gold output in the New World.

Our findings suggest that monetization is a key determinant of the fiscal capacity of states. Thus, money is not neutral even in the long run, and money is essential for the long-run trajectory of economic and political development.

Before 1500, we find large swings in monetary and fiscal capacity, with peaks at 5th century BC Athens, Pax Romana in the first two centuries AD, and early 14th century. We also find that each of these three peaks was associated with surges in silver production, respectively at Laurion, Iberian and central European mines.

Our review of the early modern period identifies several patterns. For one, the evidence corroborates the notion that the New World shock – the inflow of precious metals from the New World since the 1500s – resulted in an unprecedented increase in monetization levels in Europe, breaking the historical cycles of monetization and demonetization. Secondly, the impact of the shock on the monetization levels was real, in the sense that money stocks increased more than prices and incomes. Third, the impact of the shock was asymmetric, in the sense that it primarily affected Western Europe, and diffused to the east in a limited way, leading to a divergence in monetization levels. All in all, the continent-wide evidence also corroborates the close relationship between monetary and fiscal capacity, as consistent with our model and remaining empirical results.